Lien Recovery Study
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DRAFT #2 – 9/30/03

RESIDENCE LIEN RECOVERY FUND (RLRF) FEASIBILITY STUDY
– FALL 2003 –

From the Office of Klare Bachman, Executive Director
Utah Department of Commerce

Acknowledgements: Mr. Ted Boyer, preceding Department of Commerce Executive Director and Mr. Earl Webster, RLRF Coordinator, provided material assistance in the preparation of this study.

Executive Summary

1. Although the original directive that this study address Fund *viability* was later changed to address *feasibility,* a brief comment regarding *viability* is warranted. The RLRF is currently financially viable due to a recent special assessment on licensed contractors. As of the end of FY 2003, Fund balance was $2,246,851. Assuming legislative will and the ability to assess fees as needed, the Fund will remain viable indefinitely.
2. The key issue surrounding LRF is a policy question that can only be answered by the legislature: Should homeowners be protected from paying twice for construction goods and services? If the answer is "yes", there are many potential alternatives—public or private and with or without retaining the RLRF—for structuring that protection, as outlined in this study. There are any number of possible permutations which may be added for consideration to the alternatives listed in this study.
3. The author of this report deems the following alternatives unsuitable for further consideration due to the fatal flaws identified here and in more detail later in this report:
   - No or little ultimate homeowner protection: # 1, 4, 8
   - Constitutionality problems: # 10, 11, 14, 18
   - Prohibitive costs or mechanism: #2, 3, 6, 7, 9, 13, 15
   - Still viable considerations, based on cost effectiveness and risk allocation, include options # 12, 17, 19, OR variations on these themes.
4. At the RLRF ad hoc committee meeting of 9/30/03, Committee Chair, Representative Mike Morley, proposed an online variation of Alternative #6 – pre lien notices. Representative Morley agreed to draft a proposal for further consideration, which will be added to this report at a later date.

Introduction

During the 2003 General Utah State Legislative Session, Third Substitute H.B. 78, sponsored by Representative Gordon E. Snow, was passed. In part, Utah Code §38-11-2036 of that Bill states: "The executive director of the Department of Commerce shall initiate a study to determine the viability of the Lien Recovery Fund."

At its May 21, 2003 meeting, the Business and Labor Interim Committee determined that the Lien Recovery Fund Viability Study dictated in H.B. 78 should be broad-based and completed within four months from its meeting date, September 21, 2003. Because the Fund is presently financially viable but its future still uncertain, the Committee opted at this time to change the word “Viability” to “Feasibility.”

During the spring and summer of 2003, LFR has been the subject of several meetings of the Utah Legislature’s Business and Labor Interim Ad Hoc Committee, chaired by Representative Mike Morley. Interested parties to those discussions are shown on Attachment #1.

Background

In Utah, as in the rest of the country, by custom and practice in new construction situations, the homeowner usually hires a general contractor to oversee home construction, including subcontracting for various elements and the acquisition of necessary building materials and supplies. The homeowner or purchaser has very little involvement in subcontractor and supplier selection and payment. Neither can the homeowner access a contractor’s credit record. Therefore, he or she has little opportunity to prevent or mitigate the risk of nonpayment by the general contractor. Nor does the homeowner have recourse to small claims court, since liens cannot be foreclosed in that venue.

The homeowner, or more generally the homeowner’s construction lender, may pay associated costs by:

1. Paying the general contractor directly, with instructions to pay the subcontractors and suppliers.
2. Issuing joint checks to the general contractor and the subcontractor or supplier.
3. Issuing checks directly to the subcontractor or supplier.

The chosen payment option should be controlled by terms of the contract. Current law does not provide any specifics, probably because it would be very difficult to dictate and enforce payment method by law. However, option number 3 above, if practiced exclusively, would eliminate homeowner lien problems in most cases except where check forgery is involved.

Fund History & Purpose

Prior to the creation of RLRF, a contractor, subcontractor or supplier that had provided labor or materials to a residence for which he/she was not paid would file a notice of mechanic’s lien against the subject residence. That lien effectively served as an encumbrance of record against the title to the residence. After the filing of the notice of lien, the residential owner had very few alternatives, none of which were very attractive:

1. The residential owner could hope that the lien claimant never pursued foreclosure of the mechanics’ lien and that the notice of lien would expire by statutory term at some point in the future.
2. The homeowner could pay the subcontractor or supplier that had filed the lien, in essence paying twice for the same work. The homeowner could then pursue the nonpaying contractor for breach of contract to recover the duplicate payment. However, in practice, bankruptcy and asset shielding by the contractor usually results in those contractors being judgment proof thus precluding the homeowner from collecting on indemnification.

3. A final alternative was to let the lien claimant file a lien foreclosure judicial action and hope to successfully defend the case in court. However, the fact that the residential owner had paid the full contract price for the initial construction or remodeling of the residence was not a defense to the lien foreclosure action. Consequently, in many, if not most cases, the homeowner either paid a second time for the materials or labor or the home was foreclosed.

Against this backdrop, the Utah legislature decided it was appropriate to shift the homeowner's vulnerability and burden related to construction liens to the construction industry as a whole. In its1994 regular session, the Utah legislature passed the Residence Lien Restriction and Lien Recovery Fund Act, found in Title 38, Chapter 11, Utah Code Annotated. The Act created an expendable trust fund and became effective on May 1, 1995.

As its name implies, the RLRF covers claims on residential rather than commercial construction. At the time of RLRF creation, the legislature determined that most commercial property owners have legal counsel and business sophistication sufficient to protect themselves from having to pay twice for the same services. The legislature further concluded that residential property owners frequently lack such counsel and sophistication and needed protection provided by the Act.

The Fund has been administered since inception through the Utah Department of Commerce Division of Occupational & Professional Licensing. RLRF is a last-resort source of payment for persons, including subcontractors, suppliers, and laborers, who can no longer recover for goods and services by bringing mechanic's liens against residential property or by bringing civil action against the homeowner. Lack of recovery may be due to contractor or developer bankruptcy, being shielded from judgment via a structured trust, or simply "skipping" town.

Purpose of the Fund was two-fold:

1. To protect homeowners who had paid the full contract price for the original construction of the residence or remodel of the residence from the filing of mechanics' liens against the residence.
2. To provide a source of payment for contractors or suppliers who had performed work on a residence and enhanced the value thereof but did not receive payment from the general contractor or subcontractor for whom they worked.

Note: A corollary function of the Fund is the invocation of appropriate disciplinary action against the contractor's license of a person or entity whose non-payment of labor or materials results in the payment of a claim from the fund.

The Fund has been controversial since its inception for reasons discussed in greater detail later in this document. Attempts to address problems with the Fund's operation were made, in part, through amendments to the Act in 1996, 1997, 1998, and 2001, as well as with Legislative performance audit recommendations made in 2000. In addition, RLRF ad hoc or task force committees, comprised of legislators, well-balanced industry representation, and DOPL staff, were active in 1994, 1999, and 2001. In the final analysis, each of these committees concluded that homeowner protection was necessary and that the Fund should be retained. Their work also resulted in refining the RLRF process to make it more effective and efficient.

Funding

The RLRF has been funded through initial and special assessments collected by the Utah Department of Commerce Division of Occupational and Professional Licensing (DOPL) from licensed contractors and suppliers registered as qualified beneficiaries accordingly to law. The initial assessment for qualified beneficiaries was $195 paid upon application of the contractor's original license or the first renewal after creation of the Fund. In 1995, total Fund claim expenditures were $173,929. In FY03, that amount had increased to $1,399,034.

Due to the increased number and amount of claims over time, as well as decreased interest income, by the year 2003 the RLRF was unable to sustain its statutory minimum balance of $1,500,000. This necessitated a special assessment of $125 in May 2003 to all contractor licensees. Therefore, since the Fund's inception in 1994, each licensed contractor, as required by law, has paid a total of $320 each. If prorated annually, the contractor contributions equal $40 each. Based on an average of 15,000 contractors, those fees have generated approximately $4.5 million dollars in Fund revenue. In addition, 117 suppliers and 48 miscellaneous companies, (architectural, engineering and land surveyor firms), have paid the $300 fee to participate in the Fund. Those suppliers and firms not choosing to pay a fee are ineligible for its coverage. Those covered by the fund are referred to as "qualified beneficiaries".

Functionality

RLRF prohibits anyone who provides services or materials for residential housing construction from either maintaining a mechanic's lien against a residence or obtaining a civil judgment against a homeowner for construction expenses, provided the homeowner complies with the following requirements:

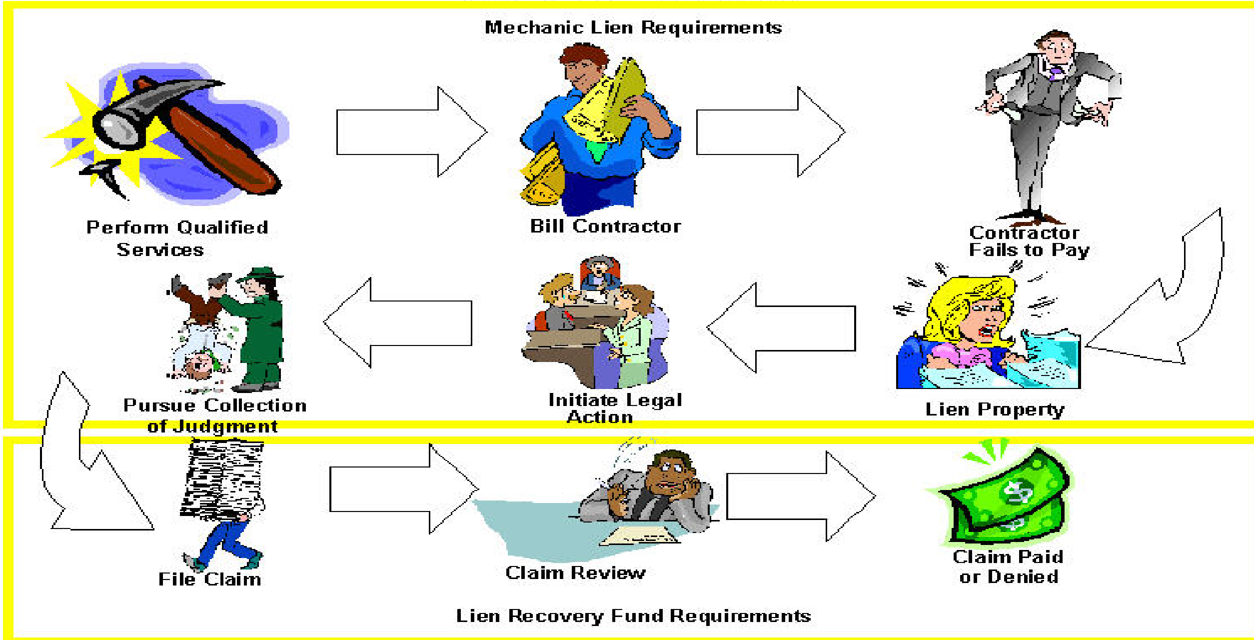
1. The homeowner must enter into a written contract with a licensed contractor, a contractor exempt from licensure, a factory built housing retailer, or a real estate developer for construction on or the purchase of a single family or duplex residence. (Contractors exempt from licensure include those doing work for less than $1,000 and not including plumbing or electrical work, jobs involving non-structural steel, such as iron railings, and retail store installations, such as cabinets from Sears.)
2. The property must qualify as residential construction and must be occupied within 180 days of the completion of construction.
3. The homeowner must pay the contractor or real estate developer in full according to terms of the written contract and any amendments to the contract.

Assuming the above requirements are met, the claimant supplier or subcontractor must then obtain a court-issued judgment against the non-paying contractor. Only then may claim against the RLRF be made. All legal documentation must be submitted, along with a completed application form, to RLRF administrators. A brief summary of the overall process is as follows:

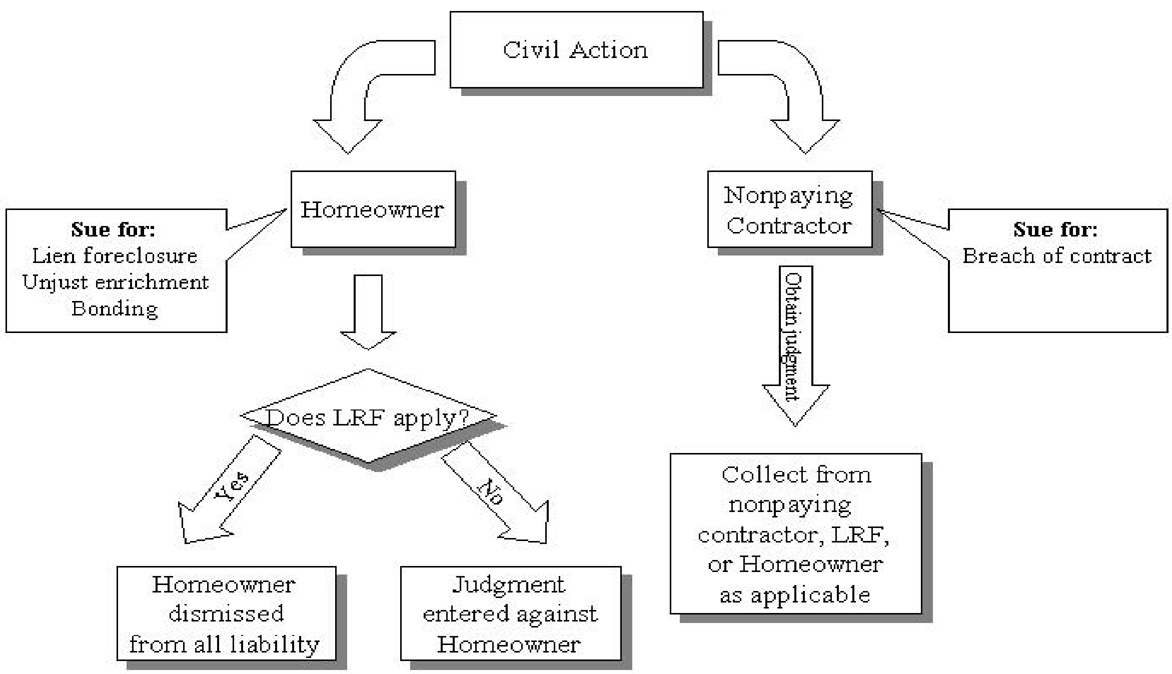
1. Homeowner enters into written contract with licensed contractor.
2. Construction services are performed and contractor paid by homeowner.
3. Contractor is billed for subcontractor or supplier services.
4. Contractor fails to pay.
5. Lawsuit filed and judgment obtained.
6. Lien recovery claim is submitted to RLRF
7. Claim is paid or denied.

Following are separate visual representations of both the overall claims process and legal proceeding.

The Overall Process



Legal Proceeding



NOTE: RLRF claims are typically submitted by claimant's legal counsel, and require the following documentation. These criteria are subject to RLRF administrator interpretation for sufficiency and may be subject to change. Refer to R156-38-204a for further detail and underlying instructions.

1. **Proof of written construction contract and accompanying contract documents**.
2. **Copy of civil finding**.
3. **Proof of contractor licensure at time contract was entered into**.
4. **Proof of contract payment in full**: complete certified HUD-1 settlement statements or copies of checks made payable to the original contractor equaling the contract price are required; an affidavit from the homeowner stating the contract was paid in full is not sufficient without corroborating evidence.
5. **Proof the civil action was filed within 180 days of last date of qualified services being provided:** a) copy of complaint clearly showing court date stamp; b) copy of Notice of Commencement of Action previously filed with and accepted by the Division; and c) copy of Notice of Filing of Bankruptcy by nonpaying contractor.
6. **Proof judgment was obtained against nonpaying party:** copy of judgment or copy of bankruptcy notice showing judgment could not be entered.
7. **Proof claimant attempted to collect on judgment:** a) copy of Motion & Order in Supplemental Proceedings; b) and brief explanation of outcome of Supplemental Proceeding and/or Writ of Execution against nonpaying contractor; and/or c) copy of bankruptcy notice showing Supplemental Proceeding could not be ordered and/or held.
8. **Proof residence is owner-occupied:** completed and notarized Owner-Occupied Residence affidavit or civil finding. Other documentation may be accepted as determined by RLRF staff.
9. **Proof of qualified services:** a) complete, legible invoices showing dates services were provided, location services were provided to, nature of services and amount billed; b) civil findings including nature, timing and amount of qualified services; and c) other documentation as determined by RLRF staff.
10. **Affidavit and documentation in support of attorney fees and costs**.
11. **Complete Certificate of Service.** (To ensure due process delivery of claim to non-paying party.)
12. **Filing fee for each property**. (The RLRF statute authorizes a $120 processing fee.)

NOTE: The RLRF did not change any pre-existing requirement for mechanic lien foreclosure.

After claimant application and data entry by RLRF staff, the RLRF Coordinator reviews the claim and prepares a recommendation to the RLRF Board as to claim disposition. On average, application to claim disposition takes 75 days, including a 30-day notice period for the non-paying party to respond to allegations or make good payment. RLRF Board meetings are typically held monthly, where action may include approving full or partial payment or denying the claim as non-payable. Only through affirmative withdrawal by the claimant can a claim be dismissed. Recoverable fees include payment for qualified services, pre and post judgment attorney fees and costs, and interest. As amended by HB 78, attorney fees are capped at 15 percent of qualified services, and the rate for interest expense reimbursement is adjusted annually using the prime rate in effect on the first business day of the year as published in the Wall Street Journal. The court and subsequent RLRF action provides claimant due process. Thus, no appeal mechanism is provided for partial payment and denied claims.

In sum, the Fund functions as intended by the Legislature: it collects revenues, pays claims, and homeowners are protected in the process.

Performance

The following statistics for years 1997 through 2003 have been maintained and provided by DOPL.

Table 1: Revenues, Expenditures & Fund Balance Information for Fiscal Years 1997 - 2003

	1997	1998	1999	2000	2001	2002	2003
Total Fund Revenues	$ 489,460	$ 825,560	$ 529,293	$611,957	$ 570,777	$ 575,175	$1,802,198
Net Claim Payments	4,805	306,375	261,126	390,757	1,245,779	1,061,358	1,399,034
Excess (Deficit) of Funds after paying Claims	$ 484,655	$ 519,185	$ 268,167	$221,200	$ (675,002)	$ (486,183)	$ 403,164
Administrative Expenses	89,709	140,747	199,305	154,541	207,692	239,751	267,028
Net Increase (Decrease) to Fund Balance	**$ 394,946**	**$ 378,438**	**$ 68,862**	**$ 66,659**	**$ (882,694)**	**$ (725,934)**	**$ 136,136**

Total Revenues	**$5,893,880**	
Total Claims Paid	**4,669,234**	
Total Administrative Expenses	**$1,298,773**	
End of FY03 Balance	**(74,127)**	**(Negative balanced addressed via special assessment.)**

Note: Administrative expenses include RLRF staff salaries and benefits, supplies, print, postage, etc.

Table 2: Expenditures by % for Fiscal Years 1997 – 2003

Expenditure	1997	1998	1999	2000	2001	2002	2003
Claim Payments	5.1	68.5	56.7	71.7	85.7	81.6	84.0
Fund Employees Salary & Benefits (3 FTEs)	98.2	30.5	34.3	20.5	9.6	11.5	8.4
Legal Counsel	0.0	0.0	8.0	6.0	2.8	5.9	6.7
Supplies/Printing/Postage	1.1	0.1	0.6	0.8	2.3	0.7	0.4
DP/Communications	0.2	0.6	0.0	0.4	0.4	0.1	0.4
Miscellaneous	-4.6	0.2	0.4	0.7	0.2	0.2	0.2
Total Administrative Expenses	*94.9*	*31.5*	*43.3*	*28.3*	*14.3*	*18.4*	*16.0*
Total Expenditures	*100*	*100*	*100*	*100*	*100*	*100*	*100*

Table 3: Claims Volume for Fiscal Years 1997 - 2003

Fiscal Year	# Claims Filed	# Claims Closed	Net Amount of Claim Payments
1997	49	35	$ 4,805
1998	119	77	306,375
1999	147	181	261,126
2000	253	161	390,757
2001	357	364	1,245,779
2002	331	261	1,061,358
2003	270	302	1,299,034
Totals	*1,526*	*1,381*	*$4,669,234*

Tables 1, 2 & 3 Conclusions & Commentary:

1. Administrative costs have dropped precipitously as claim volume has grown and Fund administration becomes more efficient.
2. Over the life of the Fund, approximately the same amounts of claims have been denied as have been paid. However, claim volume has risen 763% between 1997 and 2003.
3. While variables such as the economy and market conditions most assuredly have an effect on LRF statistics, the more recent dramatic increase in volume and amounts of claims is primarily due to: 1) people having become familiar with the Fund and its operation; and 2) a subsequent modification enacted by the 2001 Legislature to expedite claims processing.

Table 4: Distribution of Claims by Amount – 1996 - 2003:

Less than $1,000	24.4 %
$1,000.01 to $2,500	32.9 %
$2,500.01 to $5,000	21.0 %
$5,000.01 to $10,000	13.7 %
Above $10,000	8.0%

Table 5: Distribution of Claims Paid by Type & Recipient: 1996 - 2003

New construction	88.3%
Remodels or repair jobs	11.7%
Suppliers	66.0%
Subcontractors	33.6%
Laborers	0.4%

Table 6: Non-paying Party (Cause of Claims): 1996 – October 1, 2003

Type	# Claims	Amount	%
General Contractors	787	$4,124,954	82.5
Subcontractors	123	597,981	12.0
Real Estate Developers	64	208,403	4.2
Suppliers	4	55,830	1.1
Other	1	14,106	0.3

Table 7: Reasons for Claim Denial (January 2001 – September 2003)

Failure to respond to notice of incomplete claim	37	38.9%
Failure to meet 180-day civil action deadline	29	30.5
Claimant not registered with RLRF	16	16.8
Residence not owner-occupied	8	8.4
Other (Non-paying party paid claim)	3	3.2
Failure to meet one-year claim filing deadline	2	2.1

Tables 4, 5, 6, & 7 Conclusions & Commentary:

1. Although just three contractors caused one-third of claims to date, many homeowners were affected by their non-payments.
2. RLRF protected a total of 641 homes from mechanic liens between 1996 and 2003. Based on a total of 165,445 building permits issued throughout the State during the same time period, homes protected by RLRF represent .387 percent of the total. When total fund expenditures are divided by the 641 protected homes, cost of protection for each home averaged $7,284. However, these numbers should be interpreted in light of the fact that the number of building permits issued includes a significant number issued to people where contractors were not involved; i.e., owner-builder projects. Neither do the statistics provided reflect the fact that the mere existence of the RLRF has served as a preventive mechanism and has surely protected homeowners from not needing to ultimately rely on its relief.
3. It is very significant to note that in the past nine years of Fund operation, not a single claim has been filed by a licensed professional.
4. Due to legal opinion that limits on recovery were unconstitutional, the previous lifetime cap of $500,000 for payment to qualified beneficiaries was lifted by statutory amendment in July 2001.
5. Assuming that materials equate to approximately two-thirds of overall construction costs and labor accounting for approximately one-third of costs, the distribution of claims as shown in Table 5 appears logical--with suppliers having received approximately two-thirds of claim payments and subcontractors having received one-third of payments.

Contractor Perspectives/Concerns

A. Contractors are unhappy with the current RLRF law for the following reasons:
   a. Their profession pays the majority of fees for funding while primary benefits go to suppliers and, secondarily, to subcontractors and homeowners. Philosophically, they do not believe it fair that contractors must pay for the homeowner’s lien protection when in other instances—such as for homeowner’s or car insurance—homeowners expects to pay for their own coverage.
   b. Only a small percentage of contractors cause lien problems for homeowners, subcontractors and suppliers, yet all licensed contractors pay for the misdeeds of these few.

B. Length of time to file claim:
   a. Most of the frustration now centers around the lengthy time required to complete civil proceedings, undertaken as part of the mechanic’s lien foreclosure process, precedent to filing with RLRF, a problem lying with the judicial system and out of the realm of managerial control. This requirement existed prior to RLRF existence and is used to ensure that the Fund remains payer of last resort.
   b. Time spent by DOPL to actually process a claim averages 75 days—not including time spent waiting for claimants to provide missing documentation or correct other claim deficiencies—including a 30-day waiting period to provide the nonpaying party an opportunity to respond to claim allegations. Further delay may be incurred depending on when the monthly RLRF Board meets to act on filings. However, before streamlining the process, DOPL processing time averaged close to six months.

C. Lack of knowledge:
   a. In response to 2001 RLRF audit findings, DOPL invited all Utah licensed contractors, numbering approximately 21,000 invitations, to free seminars explaining the program, with costs absorbed by DOPL. The seminars were held throughout the State so that no one had to drive more than 100 miles to attend. Furthermore, seminars were scheduled after regular working hours or during weekends to accommodate work schedules. Seminars were extremely well received by the total of 450 attendees. Including requests for information from an additional 1,200 contractors, 7.9 percent of total licensees took advantage of DOPL's education efforts. RLRF staff plan to repeat the seminars in 2004, based on requests from over 100 contractors over the past couple years. Hopefully, attendance will improve with future presentations.

D. Filing deadlines:
   a. Utah Code Ann. §38-11-204(3) (c) (i) (A) states that the claimant must file a lawsuit against the nonpaying party within 180 days of the last date the claimant provided qualified services on the incident residence. This deadline is mirrored from the mechanic's lien law and would exist with or without RLRF.
   b. Most complaints centered around a second statutory deadline which required the claimant to file within 120 days of the date judgment was entered against the nonpaying party or the date the nonpaying party filed bankruptcy. This problem was remedied by the Legislature in 2001, when the Act was amended to extend the filing deadline to one year.

<u>Supplier Perspectives/Concerns</u>

A. Suppliers in general favor continuation of the RLRF because it serves as an additional protection from bad debt.
B. Suppliers believe their credit practices are quite rigorous and that supplier claims on RLRF are in large part unavoidable.
C. Suppliers would vehemently oppose any changes to the RLRF that would result in their being made less whole than they were under the prior Mechanic's Lien Law.

<u>Attorney Perspectives/Concerns</u>

Amendments to the RLRF law in the last session placed a cap on interest and attorney's fees, which helped staunch expenditures somewhat. However, caps created a new problem: Historically, almost 60 percent of the claims filed against the Fund were under $2,500. By capping attorney's fees at 15 percent of the amount claimed, attorney fees are limited to $375 or less for the majority of claims. For this, the attorney would have to meet with the client, review the contracts, file suit against the non-paying contractor, obtain judgment from that contractor and then handle the claim against the Fund. Few, if any, attorneys would be willing to provide that level of service for such a small amount of money.

<u>DOPL Perspectives/Concerns</u>

DOPL staff view the Fund's early years as difficult. As with any new law, education of stakeholders, (homeowners, contractors, suppliers, attorneys, etc.), presented a huge challenge. Several substantive changes to the law over the years have had very positive results but further complicated the educational process. Before refinements were made—particularly concerning filing deadlines—staff often received the brunt of criticism that the Fund was too cumbersome and took too long to pay claims. Based on the number and amount of claims now being processed, as well as their having to field few complaints regarding the RLRF process, staff now believes the Fund in its present form is successfully meeting its mission.

Review of Other States' Approaches to the Problem

Table 7, below, illustrates the status of recovery fund programs in other states as of the most recent review in 1999. The Utah RLRF is modeled after that of Michigan. Seventeen other states now have some form of homeowner protection against liens, and the trend seems to be that remaining states are interested in creating programs as well.

Continued on next page.

Table 7: State Contractor Recovery Funds – 1999 Review

State	Start	Recovery Fund (RF) Name *Governing Entity*	Beneficiary	Revenue Source
Nevada*	2001	Residential Construction RF State Contractors Board	Homeowners	Contractors
Utah	1994	Residence Lien RF Division of Occup./Prof. Licensing	All parties	Contractors/ Suppliers
Alabama*	1993	Home Building & Improvement RF Home builders Licensure Board	Homeowners	Contractors
Florida	1993	Florida Construction Industries RF *Construction Industry Licensing Bd.*	Natural Persons	Building Permits
Minnesota	1993	Contractor's RF Commissioner, State Treasury	Homeowners	Contractors
Massachusetts	1992	Residential Contractor's Guaranty F *Building Regs. And Standards Board*	Homeowners	Contractors
N. Carolina	1991	Homeowners RF State Licensing Board	Homeowners	Building Permits
Connecticut	1989	Home Improvement Guaranty F The Commissioner	Homeowners	Contractors
Tennessee** (Dissolved)	1989	Home Improvement Guaranty F Home Improvement Commission	Homeowners	Insufficient
Indiana*	1988	Plumbers RF The Plumbing Commission	Any Persons	Plumbers
Maryland	1985	Home Improvement Guaranty F The Home Improvement Commission	Homeowners	Contractors
Michigan*	1982	Homeowner Construction Lien RF Dir. Of Licensing and Regulations	All parties	Contractors
Arizona	1981	Residential Contractors' RF The Registrar of Licensing Board	Homeowners	Contractors
Virginia	1980	Virginia Contractor Transaction RF Board for Contractors	Homeowners	Contractors
New Jersey	1979	New Home Warranty Security F *Dept. of Community Affairs*	Homeowners	Home Sales
Hawaii	1974	Contractors RF Contractors License Board	Homeowners	Contractors

* Not actively paying out claims.
** Dissolved after two years in 1991.

Analysis of Alternatives to the Residence Lien Recovery Fund

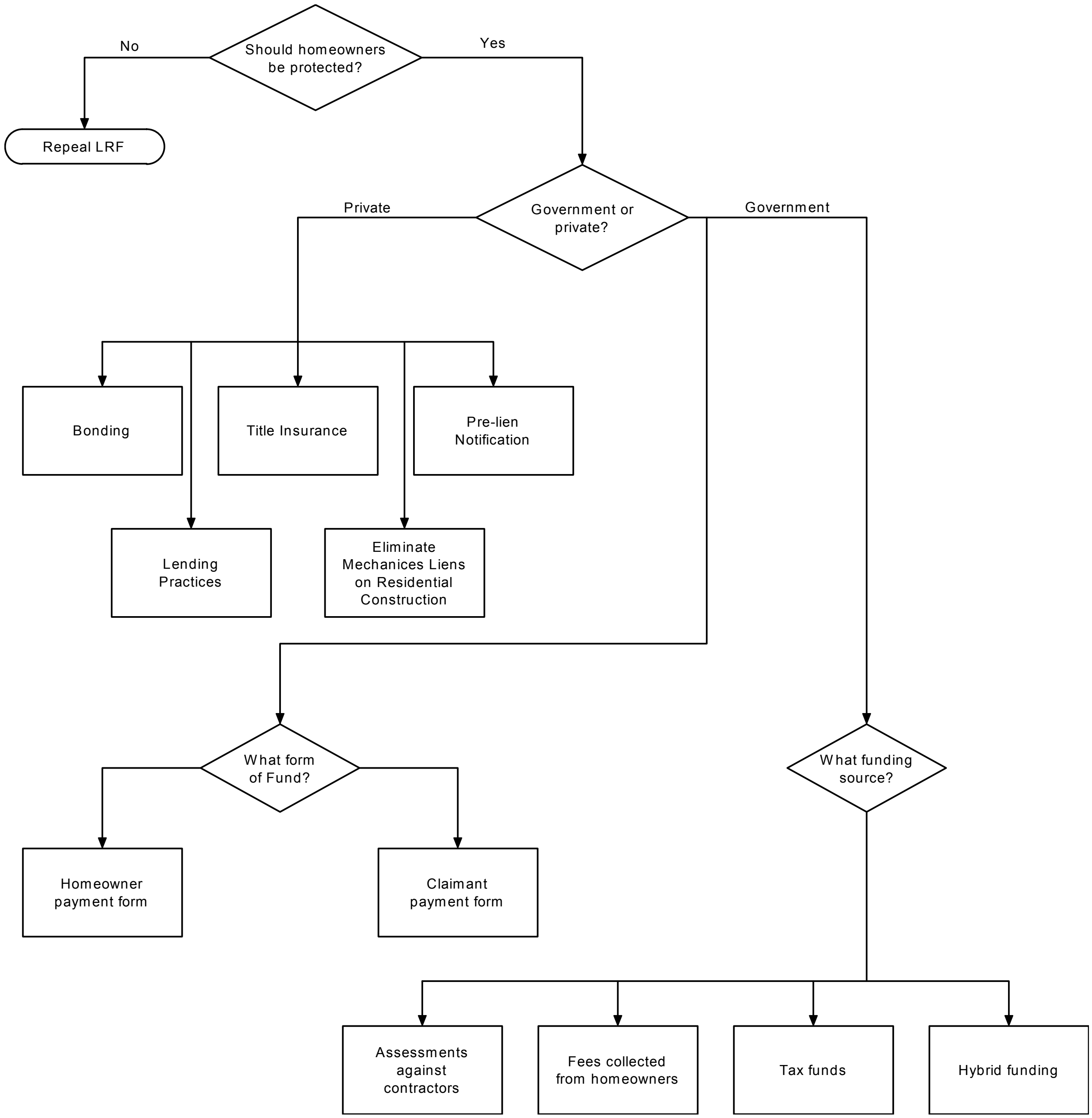
In a general sense, the RLRF and the alternatives proposed thereto are methods of allocating risk. As noted previously, the risks allocated are:

1. The homeowner, having paid the full contract price for construction or remodel of a residence, could have mechanics' liens filed against title to the residence if the general contractor did not pay subcontractors and suppliers.
2. The second risk to be allocated is a corollary of the first—namely, to provide a source of payment of those subcontractors and suppliers who have not been paid for goods or services yet have performed the terms of their contract.
3. Finally, there is a risk of nonpaying contractors continuing to prey on homeowners acting in good faith. RLRF currently reduces this risk by providing that the contractors not paying for contract work or materials, thereby creating a claim against the Fund, lose their license automatically.

Prior to addressing the questions of whether or not the Fund is feasible in its present form or can become feasible through refinement or revision, a consideration and analysis of alternatives is indicated. The following Residential Lien Recovery Fund alternatives have been suggested:

1. Eliminate RLRF and revert to the prior mechanics' lien law
2. Bonding of construction projects
3. Bonding of licensed contractors' licenses
4. Use of a bond in place of the lien or to obtain release of a lien
5. Title insurance
6. The filing of a preliminary notice of lien prior to commencement of construction
7. Shifting risk to construction lending institutions
8. Owner/buyer education either through building permit agencies or lenders
9. Eliminate mechanic's liens rights for claims less than a threshold amount
10. Eliminate RLRF and eliminate mechanics' liens rights altogether
11. Use of a state approved construction form contract
12. Bid limits and financial responsibility
13. Eliminate mechanics' liens on residences where the owners have paid the full contract price.
14. Homeowner Protection Fund
15. Retain RLRF but change funding mechanism to collect fees from homeowners via building permit in combination with subsidy from non-lapsing DOPL contractor fines
16. Retain RLRF but change funding mechanism to include supplier contributions along with contractor fees or, alternatively, limit supplier claim payments to a percentage on the dollar.
17. Retain RLRF but change funding mechanism to be shared between contractors, subcontractors and homeowners via building permit.
18. Retain RLRF but change funding mechanism to include supplier contributions along with contractor fees or, alternatively, limit supplier claim payments to a percentage on the dollar.
19. Retain RLRF but change funding mechanism to be shared between contractors and homeowners via building permit.

The following schematic presents a high-level visual representation of these alternatives—public, private or a hybrid thereof.



<u>Detailed analysis of alternatives to RLRF,</u> (specifically looking at the allocation of risks discussed above and how they are addressed by each alternative).

<u>1. Eliminate RLRF and revert to the prior mechanic's lien law</u>

Advantage:

A. The mechanic's lien approach provides a source of payment for the unpaid contractor or supplier.
B. Since its inception, RLRF has paid claims on 641 properties. This is a very small percentage of residential building permits issued during the same period. Thus, some maintain that RLRF does not justify itself in a cost/benefit analysis. Besides,

government cannot protect everyone all the time. Elimination of RLRF would eliminate the burden on current funders in terms of assessed fees.

Disadvantages:

A. Homeowner harm (paying twice for goods or services) without recourse, especially in cases of contractor bankruptcy or "disappearing." The prior mechanic's lien law placed the entire risk of nonpayment upon the homeowner. The homeowner would then have the option of paying subcontractors and suppliers attempting to defend a lien foreclosure action or simply letting the residence be foreclosed. This would be a just result in instances where the residential owner did not pay for the labor or materials performed. However, if the owner had already paid the full contract price, it would be unfair for the homeowner to pay twice. Some have argued that the homeowner has the ultimate control over the pace of construction and the payment of subcontractors and suppliers and, therefore, that result is just. However, as discussed previously, in the real world, the homeowner has little control over disbursements and the selection of subcontractors and suppliers. Furthermore, the average homeowner does not have the technical expertise to determine when a contract has been performed and whether it has been performed according to code. For example, an electrical contractor, contracted to fully wire a residence for the sum of $10,000, may tell the homeowner "I have completed half of the electrical work--please pay me $5,000." The average homeowner would not have the expertise necessary to determine whether or not the job was 50% complete nor whether it was compliant with code. Therefore, the risk of loss due to nonpayment is placed on the person least able to defend or mitigate that risk of loss.
B. The mechanic's lien approach is quite expensive and attorney intensive. Collection and/or foreclosure typically require judicial action and in addition require the purchase of a title report on the title to the property to determine the priority of the various liens.
C. Potential for nonpaying contractor continuing to do business and failing to pay subcontractors.
D. Generally speaking, a mechanic's lien has subordinate priority with respect to construction financing. Therefore, if a lien claimant forecloses on a residence to secure payment, that claimant must pay the entire mortgage balance before selling the property at sheriff's auction or from the proceeds of that sale if the mortgage lender will so allow. Therefore, in most cases mechanic's lien holders are unable to collect through the mechanic's lien process.
E. Political pressure: If the legislature were to determine homeowners no longer need RLRF protection, the only required action would be to repeal UCA Title 38 Chapter 11, the LRF Act, and make some amendments to Title 58 Chapter 55, the Construction Trades Act. However, without RLRF, the next time a number of citizens were harmed by unfair liens, the question would certainly be asked, "How can the State let this happen?" Repeal of RLRF also begs the question "Can the genie be put back in the bottle?" The media has recently run a number of stories about the Fund, and awareness of the program has grown exponentially over the past two years. Via re-creation of the Fund or a variation thereof, legislators may be inclined to assist homeowners harmed in the future through bad business practices by non-paying contractors, which would bring the issue back to "square one."

2. Privatized bonding of construction projects (aka Payment Bonding)

Background: There is currently a private contract construction bond requirement found at Utah Code §14-2-1. That section requires the owner (meaning any person contracting for construction or renovation) to obtain a bond from the contractor assuring payment for any job exceeding $2,000.

Advantages:

A. Protects the homeowner who has paid the full contract price from incurring a mechanic's lien.
B. Provides a source of payment for suppliers and contractors who have not been paid by the general contractor.
C. Provides a privatized, market-driven solution without government intervention.

Disadvantages:

A. Bonding companies desire full indemnity. Thus, except on large commercial projects, these bonds are rarely, if ever, obtained due cost of the bond and the lack of availability of payment bonds. For example, bond for a $160,000 home would typically cost $4,000. (See Attachment #1 for discussion of costs and availability by vendor.) It is estimated that 25 to 50 percent of current contractors would be unable to meet net worth and working capital qualifiers for bonding, forcing a significant number of smaller contractors out of business.
B. Although compensated for their service, bonding shifts the underwriting function to surety companies rather than to contractors, owners, or subcontractors and suppliers who should remain vigilant regarding with whom they conduct business.
C. Depending on the extent of risk, sureties frequently require collateral to protect the surety in the event a claim is asserted against the bond. Provision of that collateral would probably fall on the homeowner again, therefore shifting the risk of nonpayment back to the homeowner. The collateral may, in fact, take the form of the residence being constructed for people without other valuable collateral at their discretion.
D. Enforcement would have to be dependent on educating homeowners that they must ensure their contractor is bonded and that the consequence of not doing so means the homeowner incurs personal liability for unpaid subcontractors and suppliers. Once the public became educated, unbonded contractors would be unable to find work, but ensuring public education would be quite expensive and virtually impossible even over time.
E. Does not deal with the risk of nonpaying contractors continuing in the business.

3. Privatized bonding of licensed contractors

Background: Many states require contractors to obtain bonds before they can obtain a license, and the type of license is determined by the amount of the bond obtained.

Advantages & Disadvantages Same as #2 above, Bonding of Construction. Under this scenario, coverage would be provided to the homeowner, subcontractors and suppliers. However, cost to the contractor and the availability of product again appear to be prohibitive. Bonding as a prerequisite to licensure would impact Utah's Construction Trades Act, requiring an independent study of its own. Even small bonds, for say $10,000 or less, cost up to $250. Simply put, the cost of a license bond would exceed the cost of contractors' contributions to the

Lien Recovery Fund and would have to be paid annually as long as the contractor is in business.

4. Privatized bonding to obtain release of a lien

Background: One alternative to the Residential Lien Recovery Fund is a hybrid of permitting mechanics' lien filings against the residence while also permitting the residential homeowner to provide a bond in place of the lien or a bond to obtain release of the lien.

Advantages:

A. By releasing the lien, the homeowner is freed from an encumbered title and can use the collateral for other borrowings.
B. Homeowner would opt out of historical scheme involving mechanics' liens, breach of contract, unjust enrichment, and failure to post a bond.
C. Provides a source of payment for unpaid contractors and suppliers.

Disadvantages:

A. Using a bond in this fashion again places all risk on the homeowner and merely delays the date of reckoning because unpaid contractors will assert a claim against the bond, and if the surety pays, the surety will seek redress from the homeowner.
B. Does not address the risk of non-paying contractors continuing in the business.

5. Public bonding

Background: Mr. Clair Jaussi, Attorney, presented this proposal at a recent meeting of the RLRF Ad Hoc Committee. It postulates that:

A. Public bond would be required on all residential building permits before the permit could be issued, with payment at time of issuance.
B. The bond could only be purchased by licensed contractors or legitimate "owner builders". (Note: Even though the "owner-builder" is exempt from licensure, s/he must still use licensed specialty contractors for any work not performed by the owner-builder.)
C. DOPL would administer the bonds, with claims and proof of claims by subcontractors and suppliers being made directly to DOPL without involving the homeowner.
D. "Bondability" of the contractor or homeowner who purchased the bond would be suspended until the problem is resolved.
E. Funding source would consist solely of bond premiums collected at time of building permit issuance.
F. The fund would be reduced or replenished as needed by incremental changes to the premium.
G. Since no contractor license would be suspended or revoked under this model, there would be no violation of any bankruptcy stay.
H. At time of implementation, the existing RLRF Act would be repealed, with fund balance transferred to the new public bond fund.

Advantages*:*

A. Streamlines entire process of homeowner protection. Homeowners would need only to provide proof of bonding.

B. Bonding cost would be less expensive than other alternatives because no underwriting would take place and no profit motive would exist as with a private bonding company.
C. Speeds claims processing.
D. Imposes duty of funding and risk allocation only on people who purchase bond permits for residential construction.
E. Eliminates animosity existing between various groups in construction industry caused by present system.
F. Eliminates non-paying parties by suspending "bondability" until any problems are resolved.
G. Would not put smaller contractors out of business, as might performance or contractor bonding.

Disadvantages:

A. Practical implementation would require education, structuring requirements to prevent fraudulent or abusive claims, and determination of bond premiums, which—even though this option is less expensive than other bonding alternatives—would probably cost between $100 and $300 per building permit. Fees assessed on small projects would represent a larger percentage of the total and would therefore be particularly onerous. Other alternatives are less expensive.
B. Ensuring due process rights through the determination of applicant's ability to be bonded may pose prospects of litigation when an applicant is denied.
C. Does not address non-paying contractors remaining in business.

6. Title insurance

Background: Expanded title insurance would cover mechanics' liens recorded after closing. Depending on the type of product purchased, the reputation of the contractor, and the amount of the purchase price financed by the buyer the cost of the additional coverage can be as little as 10% more than a traditional policy or as much as 400% more than a traditional policy. (See Attachment 2 for vendor cost comparison information.)

Advantages:

A. Protects homeowner from liens and paying twice.
B. Provides a source of payment for unpaid contractors and suppliers.

Disadvantages:

A. Title companies will typically not issue insurance without guarantee of no liens, such as through the RLRF. Thus, eliminating RLRF renders this solution moot. Lacking the guarantee, title companies would increase price to cover additional risk. Generally speaking, the cost would be prohibitive at one and a half times retail cost of title insurance or more. Depending upon the size of the project, this could cost additional hundreds of dollars per residence and there are approximately 20,000 residences constructed each year in the state of Utah, plus remodel work.
B. This solution would only be available where real property was transferred as part of the transaction. Thus, if the owner of a private construction project were to own the property on which the construction was being built, there would be no title insurance issued and thus no protection.

C. May or may not force a significant number of smaller contractors out of business, depending on contractor credit risk.
D. Does not address risk of non-paying contractors continuing in business.

7. Filing of the preliminary notice of lien prior to commencement of construction

Background: Filing of a preliminary notice of lien is already required in certain circumstances but not generally in residential construction.

Advantages:

A. Would ensure that homeowner and lender know what subcontractors and suppliers are supposed to be paid and how much. Theoretically would greatly reduce the ability of general contractors to misapply funds.

Disadvantages:

A. Does not allocate the risk of non-payment away from the residential homeowner. If the homeowner wanted to be responsible for paying all the bills, he or she would enter into contracts with the several specialty contractors directly rather than hiring a general contractor.
B. Notifying lenders without obligating them to pay subcontractors and suppliers creates construction delay, meaningless and expensive paperwork and/or legal work prior to commencement of construction.
C. Lenders will not be subordinated.
D. Would exclude spec homes since homeowner does not take possession until closing.
E. Most residential homeowners would be unable to prepare and file the notice of lien prior to commencement of construction.
F. Many small subcontractors lack the computer and accounting expertise and staff resources to ensure proper pre-lien filing. For potentially hundreds of jobs and hundreds of thousands of notices, they would have to track where and when materials and/or labor went into the project, as well as when and to whom notices were to be sent. However, non-filing would prohibit them from collections on residential work.
G. Suppliers fear the process would substantially increase their workload and costs.
H. County clerks would experience a dramatic increase in filings that would be difficult to mange.
I. Does not address risk of non-paying contractors continuing in the industry.

8. Shifting the risk of non-payment to construction lending institutions.

Advantages:

A. Privatizes risk by requiring lending institutions to ensure payment via issuance of joint checks payable to the contractor and subcontractor/supplier or by ensuring payments are made to subcontractors and suppliers as a condition for the contractor drawing on the construction loan. Lending institutions are in a very good position to do that based on having the necessary experience and technical knowledge.
B. Approximately 90 percent of all RLRF claims involve projects funded through construction loans. Thus, nearly all LRF claim volume would be eliminated if lenders were required to ensure the contractor properly applied payments.

C. This option addresses the problem of nonpayment on "spec" homes that do not qualify as owner-occupied residences, consequently falling outside the purview of RLRF.
D. This approach has been successfully utilized in Montana.
E. Protects homeowner from paying twice.
F. Provides protection to subcontractors and suppliers.

Disadvantages:

A. Financial institution costs would, of course, be passed on to homeowners (borrowers).
B. The banking industry is very reluctant to take on this additional responsibility and will challenge any legislative mandate to do so.
C. Contractors could circumvent the joint check requirement by issuing the subcontractor or supplier an NSF check in exchange for the subcontractor or supplier endorsing the draw check. However, the Montana mechanics' lien law provides some homeowner protection by making the lender a subordinate creditor of all mechanics' lien holders. Therefore, the lender cannot dissolve liens by simply foreclosing the property. Further, if a mechanic's lien holder forecloses the property, the lender gets paid only the residual left after all mechanic's lien holders are paid. The net result is that lenders are very careful about making sure contractors properly apply draws.
D. Does not address the risk of non-paying contractors continuing in the business except to the extent that those contractors would have more difficulty obtaining construction financing.

<u>9. Owner/Buyer RLRF education</u>

Background: As noted previously, awareness of the RLRF has grown exponentially in the construction trades industry and legal community. Owners and buyers could also better protect themselves from the filing of lien claims if they were educated about the process.

Advantages: Also noted previously, some may argue the homeowner should accept ultimate responsibility for his/her construction since they are the beneficiary.

Disadvantages:

A. Empirically, homeowners do not avail themselves of this education through their own initiative until in need of lien recovery.
B. Without relying on a mechanism to insure that education was provided prior to construction commencement, it would be extremely difficult to provide sufficient education for owners and buyers so that they would have the technical knowledge and experience to mitigate or eliminate the risk of non-payment of subcontractors or suppliers. That mechanism could not be provided without reliance on and cooperation from lenders and/or building permit offices to distribute educational brochures on this subject.
C. Even if an educational brochure were provided with every building permit approval, reliance on the contractor would still be needed to insure that the homeowner received it, since the contractor often is made responsible for interaction with permitting authorities.
D. Education may still not adequately protect the homeowner from non-paying contractors.
E. Education does not provide a source of payment to unpaid subcontractors or suppliers.
F. Education does not address the problem of non-paying contractors continuing in business.

10. Elimination of mechanics' liens rights for claims less then a threshold amount

Advantages: Elimination of mechanic's liens rights for smaller claims, say less than $5,000, would protect homeowners from some of the risk (small claims) of non-payment by a general contractor.

Disadvantages:

A. Does not provide source of payment to contractors or suppliers. They would presumably have to revert back to the judicial system to file suits for collection, which tends to be expensive and very time consuming.
B. Does not address the risk of non-paying contractors continuing in the industry.
C. Would most likely be overturned as an unconstitutional violation of the equal protection clause in that protection would be provided for lien a claimant whose claim totaled $5,000.01 or more but not for a claimant whose claim only totaled $4,999.99.
D. Claimants could still sue under the failure to obtain bond or unjust enrichment defenses.

11. Elimination of mechanics' liens rights altogether for residential construction:

Background: This could be accomplished by either amending the Mechanic's Lien Law to exclude residential construction or by retaining the lien protection provision of the RLRF Act but eliminating the Fund itself.

Advantage:

A. It ends controversy surrounding RLRF.

Disadvantages:

A. Subcontractors and suppliers would be vehemently opposed to losing lien rights.
B. Lien rights have existed for so long that many attorneys believe eliminating it would violate state and federal constitutions.
C. Financial impact on contractors and homeowners would be unpalatable if suppliers eliminated credit accounts and forced all contractors to buy materials for cash on delivery. At least half of contractors would be forced out of business, and the remainder would incur substantially higher operating costs due to interest on working capital loans. These costs would be passed on to homeowners in the form of higher construction purchase prices. Because construction is a major economic engine, this situation would have a negative impact on the economy as a whole.

12. Use of a state approved construction form contract

Background: This boilerplate contract would be used to reduce the number of claims on the RLRF without Fund elimination. It theoretically would contractually allocate risk of non-payment among the parties. It would specify homeowner and contractor responsibility, payment terms, conditions and mechanisms, construction timeframes and completion date, materials to be used, how changes and "add-ons" are dealt with, and, a RLRF education section. A similar contract has been used for new construction in the real estate industry with some success.

Advantages:

A. Could be a boon to especially small contractors or those new to the industry who may not currently use a contract designed to provide them with adequate protection from non-paying homeowners.
B. Allows for homeowner education.
C. Would provide a preventive approach to avoiding contract disputes and a more solid basis for deciding those disputes in a legal arena if necessary.
D. Cost-effective when compared to other approaches. Primary costs would be for education and enforcement, which would be incurred with most other alternatives.

Disadvantages:

A. Contractors having developed their own customized contracts based on individual experience and preferences may not be amenable to the government dictating the contract form.
B. The State is limited in its ability to interfere with contracts. Presumably, however, requiring use of a State-approved contract would survive a legal challenge. Even so, ensuring that private attorneys include necessary provisions would be difficult.
C. Sans the RLRF as a fall-back, this option would not protect the homeowner from paying twice.
D. This option does not prevent non-paying contractors from continuing in the business.

13. The use of bid limits and/or financial responsibility

Background: Variations on this theme have been attempted in Utah and other states. In essence, contractors would have to demonstrate certain levels of responsibility in order to bid on contracts. The higher the contract amount the higher the financial responsibility requirements.

Advantages:

E. Provides methodology for removal of licenses for non-paying contractors.

Disadvantages:

A. Proof of financial responsibility is currently required of all contractors, but contractors' financial conditions vary almost daily depending on the nature and volume of work performed. For the same reason, review of financial solvency on an annual or biannual basis would rarely protect against financial irresponsibility. This safeguard has not historically avoided the problem of either protecting homeowners or unpaid contractors and suppliers.
B. Empirically, enforcement of such provisions is far too resource intensive. For example, in 2000, the Construction Trades Act was amended to eliminate the monetary work in process limit because with its current budget DOPL could perform less than one percent of the investigations needed to have enforced the limit.

14. Eliminate mechanics' liens on residences where the owners have paid full contract price

Advantages:

A. Places risk on the contractors and suppliers as in other industries to monitor their credit practices and eliminates government oversight.

B. Protects homeowner.

Disadvantages:

A. Does not provide a source of payment or address the non-paying contractor.
B. Does not avoid the age-old issues of when the contract work is complete or what constitutes full payment. Those questions would presumably be handled by the judicial system.
C. Assumes draconian credit-tightening which could force small contractors out of business.
D. Presents constitutionality problem in that it removes from the unpaid party the right to be made whole.

15. Homeowner Protection Fund

Background: Whereas RLRF pays subcontractors and suppliers on behalf of homeowners and does not reimburse homeowners themselves, the Homeowner Protection Fund is structured so that the homeowner him or herself settles liens on the residence and is thereafter reimbursed by a state-administered fund. Such a program currently operates in Florida.

Advantages: Fund is very intuitive and easy for the public to access.

Disadvantages: Requires substantial staffing to prevent fraudulent claims. Compared with RLRF, where most administrative overhead is handled by civil courts, the regulatory agency administering a Homeowner Protection Fund will incur much higher costs.

16. Retain RLRF but change funding mechanism to collect fees from homeowners

Background: Two task forces have recommended that a surcharge be assessed on building permits to fund RLRF. Lacking other subsidies, that fee would have to be in the $50 to $75 range on each permit, depending on number of permits issued. The average number of permits issued between 1995 and 2003 is 21,000 annually. The fee in essence would be the homeowner's insurance policy to provide lien claim protection.

Advantages:

A. Homeowners would be educated regarding RLRF at time of purchasing the permit or, in cases where the general contractor handled the permit, the cost would assumedly be itemized and hopefully explained to the homeowner by the general contractor. Some have suggested that the homeowner could even opt out of paying the fee, thus voluntarily declining RLRF protection.
B. A collection mechanism for this option is already in place and would not add additional costs, since DOPL already collects Uniform Building Code fees in this manner.
C. Homeowners currently pay a number of fees when constructing a new home in the form of building permits, impact fees, title insurance and the like and would likely be willing to pay an additional fee for protection against mechanics' liens.
D. The fee attached to a building permit would be substantially less than the cost of bonding or title insurance or the other alternatives considered.

Disadvantages:

A. Any new cost in addition to the many costs already incurred by homeowners during construction will be distasteful.
B. In cases where contractors handle the building permit, which is often the case, some will inevitably be remiss in explaining Fund protection to homeowners.
C. In the case of contractor-built "spec" homes, the RLRF permit fee would have to be paid for by the contractor and follow the property upon sale to the homeowner. In these instances, homeowners take ownership only after settlement and therefore likely would not be aware of protection until they availed themselves of legal counsel.

17. <u>Retain RLRF but change funding mechanism to rely solely on non-lapsing DOPL contractor fines and a homeowner fee assessed at time of building permit payment</u>

Background: DOPL historically collects an average of $200,000 per year in contractor fines.

Advantages:

A. A congruent and justifiable use of DOPL fines from a public policy standpoint.
B. Serves to educate the homeowner, since RLRF brochure would be distributed with each permit. Assuming the contractor would pass along this cost to the homeowner, even if he or she handled the building permit for the homeowner, the cost would be itemized with a contractor-provided explanation.
C. Fee collection mechanism is already in place between building permitting authorities and DOPL.
D. Provides homeowner protection and makes them responsible in part for paying for their own protection.
E. Provides subcontractor and supplier protection.
F. Provides mechanism for continuing to revoke licenses of contractors causing Fund claims.
G. Does not penalize the vast majority of reliable, bill-paying contractors at the expense of just a few "bad actors".
H. Does not appear to present any legal or constitutionality hurdles.

Disadvantages:

A. Possible perception among contractors that DOPL is overly aggressive in assessing fines to maintain RLRF.
B. Homeowner fees would have to be approximately $50 per permit in spite of the DOPL contractor subsidy. In light of the fact that homeowners incur a variety of other expected fees at the time of construction, most of which cost more than $50, this additional fee may not be seen as too onerous.
C. Potentially less revenue lapsing to the State's General Fund for other purposes.

18. <u>Retain RLRF but change funding mechanism to include supplier contributions along with contractor fees or, alternatively, limit supplier claim payments to a percentage on the dollar</u>

Background: Because suppliers have historically been the biggest beneficiary of RLRF payments, and because the industry needs to remain vigilant in extending sound credit, the suggestion has been made that they should either contribute to the Fund or receive limited reimbursement determined by a lifetime cap or for example, 90 cents on the dollar. Current legal opinion from the Attorney General's Office indicates that it would be unconstitutional to deny suppliers the right to be made whole as they were under the prior Mechanic's Lien Law. Thus, this option is rejected.

19. Retain RLRF but change funding mechanism to be shared between contractors and homeowners via building permit.

Background: This option would simply split responsibility for Fund revenues between contractors and homeowners according to any number of formulas. Advantages and disadvantages as viewed by those groups have already been discussed within other alternatives.

RLRF Peripheral Issues (Suggested statutory amendments to RLRF if it remains in its present form)

1. **Interest:** House Bill 78, Paragraph (c) is inconsistent. It states interest will be based on the current prime interest rate at the time payment was due. However Paragraph (d) states the interest rate will be adjusted on the first business day of each calendar year annually. It is unclear which of these two conflicting provisions control. Secondly, different interest rates may apply to different aspects of a claimant's claim. For example, were a claim to involve work done or services provided in December 2002, 2003, and January 2004, three different rates would apply to different portions of the claim, making interest owed calculations extremely difficult.

2. **Commercial Contractors:** Eliminate "pure" commercial contractors from having to pay RLRF fees. "Pure" must be defined in statute to eliminate confusion regarding mixed use projects such as condos at Gateway.

3. **Real estate Developer:** Definition should refer to licensed contractor.

4. **Construction Bonding:** There is currently a private contract construction bond requirement found at Utah Code §14-2-1. That section requires the owner (meaning any person contracting for construction or renovation) to obtain a bond from the contractor assuring payment for any job exceeding $2,000. This amount should be increased for inflation.

5. **Alternate Security (UCA § 38-1-28):**

In the mid to late 1990's title insurance companies began allowing certain preferred customers to "bond around" mechanics' liens at the time of closing on long-term financing or purchase of real property. While practices varied, most title companies required the property owner to post a bond or cash deposit of twice the face amount of the lien.

The existence of a cash deposit or bond as substitute security on a mechanics' lien has several advantages. First, the property owner is able to begin using the property immediately rather than having to wait while the title insurer negotiates some type of arrangement regarding the lien. Second, if the lien holder prevails in foreclosure, he receives an interest in cash rather than an interest in real property that he must then sell to receive payment for his original services. Finally, the bond becomes security separate from the real property; thus priority of claim affects only those liens to which the bond applies. Consequently, mechanics' lien holders do not face the risk of losing their liens to lending institutions that have first priority in any foreclosure action.

Recognizing these benefits and seeking to standardize the practice of bonding around liens, the legislature enacted Section 28 of the Mechanics' Lien Law, Utah Code Title 38 Chapter 1, during its 2000 session. That section provides that the bond must be 1.5 times the amount shown on the lien. Recently, several legal practitioners have indicated that 150% of the lien amount is insufficient to cover the costs, attorney fees, and interest awarded in foreclosure actions—particularly on large commercial projects.

Because the lien foreclosure falls outside the purview of Lien Recovery, the Division has only limited knowledge on the subject. However, in other matters the attorneys who raised this issue have been reasonable and accurate in their estimates of costs. Therefore, Fund personnel believe the complaint is legitimate. Lacking any expertise in lien foreclosures, especially commercial, the Division can only recommend that the legislature undertake a study to determine an appropriate minimum bond amount.

6. **Homeowner Protection Independent of Claimant Registration (UCA §§ 38-11-107(1) & 204(3)(b))**

In all debate on the Lien Recovery Act since its inception, the legislative intent has always been explicitly stated that the purpose of the Fund is to ensure homeowners do not have to pay twice for construction work. Within that objective is a requirement that the homeowner protection in Section 38-11-107(1) must inure independent of whether a lien claimant is registered with the Fund as a qualified beneficiary member. Otherwise, a claimant could void the entire purpose of the Act by simply not joining the Fund and then collecting on the lien.

About 18 months ago, the Division was made aware of a linguistic error in the statute that undermines the objective of separating homeowner protection from lien claimant membership. Specifically, Section 38-11-107(1)(a) provides that the lien claimant is barred from maintaining its lien if "the conditions described in Subsections 38-11-204(3)(a) and (3)(b) are met" by the homeowner. The problem lies in Subsection 38-11-204(3)(b), which reads:

> To recover from the fund, . . . a qualified beneficiary shall establish that . . . the owner has paid in full the original contractor licensed or exempt from licensure under Title 58, Chapter 55, Utah Construction Trades Licensing Act, real estate developer, or factory built housing retailer under Subsection (3)(a) with whom the owner has a written contract in accordance with the written contract and any amendments to the contract, **and:**
>
> (i) the original contractor, licensed or exempt from licensure under Title 58, Chapter 55, Utah Construction Trades Licensing Act, the real estate developer, or the factory built housing retailer subsequently **failed to pay a qualified beneficiary** who is entitled to payment under an agreement with that original contractor or real estate developer licensed or exempt from licensure under Title 58, Chapter 55, Utah Construction Trades Licensing Act, for services performed or materials supplied by the qualified beneficiary;
>
> (ii) a subcontractor who contracts with the original contractor, licensed or exempt from licensure under Title 58, Chapter 55, Utah Construction Trades Licensing Act, the real estate developer, or the factory built housing retailer **failed to pay a qualified beneficiary** who is entitled to payment under an agreement with that subcontractor or supplier; or

(iii) a subcontractor who contracts with a subcontractor or supplier **failed to pay a qualified beneficiary** who is entitled to payment under an agreement with that subcontractor or supplier; (emphasis added)

A strict reading of this section would require that the homeowner prove:

A. That he paid the original contractor, real estate developer, or factory built housing retailer in full;
B. That the nonpaying party did not pay the claimant; and
C. That the claimant meets all the conditions to be a qualified beneficiary under Subsection 38-11-102(17).

Such a reading poses two problems. First, a homeowner would never have the information necessary to prove the nonpaying party did not pay. That information is in the possession of the lien claimant. Second, the key requirement to be a qualified beneficiary is registration with the Fund prior to providing qualified services. Requiring the homeowner to prove the lien claimant is registered with the Fund throws wide open the ability of the lien claimant to void the Act as explained above.

To solve this problem, the Division recommends Section 38-11-204(3) be renumbered as follows:

(3) To recover from the fund, regardless of whether the residence is occupied by the owner, a subsequent owner, or the owner or subsequent owner's tenant or lessee, a qualified beneficiary shall establish that:

(a) (i) the owner of the owner-occupied residence or the owner's agent entered into a written contract with an original contractor licensed or exempt from licensure under Title 58, Chapter 55, Utah Construction Trades Licensing Act, for the performance of qualified services, to obtain the performance of qualified services by others, or for the supervision of the performance by others of qualified services in construction on that residence;

(ii) the owner of the owner-occupied residence or the owner's agent entered into a written contract with a real estate developer for the purchase of an owner-occupied residence; or

(iii) the owner of the owner-occupied residence or the owner's agent entered into a written contract with a factory built housing retailer for the purchase of an owner-occupied residence;

(b) the owner has paid in full the original contractor licensed or exempt from licensure under Title 58, Chapter 55, Utah Construction Trades Licensing Act, real estate developer, or factory built housing retailer under Subsection (3)(a) with whom the owner has a written contract in accordance with the written contract and any amendments to the contract[~~, and:~~];

(c) (i) the original contractor, licensed or exempt from licensure under Title 58, Chapter 55, Utah Construction Trades Licensing Act, the real estate developer, or the factory built housing retailer subsequently failed to pay a qualified beneficiary who is entitled to payment under an agreement with that original contractor or real estate developer licensed or exempt from licensure under Title 58, Chapter 55, Utah Construction Trades Licensing Act, for services performed or materials supplied by the qualified beneficiary;

(ii) a subcontractor who contracts with the original contractor, licensed or exempt from licensure under Title 58, Chapter 55, Utah Construction Trades Licensing Act, the real estate developer, or the factory built housing retailer failed to pay a qualified beneficiary who is entitled to payment under an agreement with that subcontractor or supplier; or

(iii) a subcontractor who contracts with a subcontractor or supplier failed to pay a qualified beneficiary who is entitled to payment under an agreement with that subcontractor or supplier;

(d) [~~(c)~~] (i) the qualified beneficiary filed:

(A) an action against the nonpaying party to recover monies owed him within 180 days from the date the qualified beneficiary last provided qualified services, unless precluded from doing so by the nonpaying party's bankruptcy filing within the 180 days after completion of services; and

(B) a notice of commencement of action with the division within 30 days from the date the qualified beneficiary filed the civil action if a civil action was filed as required by Subsection (3)(c)(i)(A);

(ii) the qualified beneficiary has obtained a judgment against the nonpaying party who failed to pay the qualified beneficiary under an agreement to provide qualified services for construction of that owner-occupied residence;

(iii) (A) the qualified beneficiary has obtained from a court of competent jurisdiction the issuance of an order requiring the judgment debtor, or if a corporation any officer of the corporation, to appear before the court at a specified time and place to answer concerning the debtor's or corporation's property, has received return of service of the `order from a person qualified to serve documents under the Utah Rules of Civil Procedure, Rule 4(b), and has made reasonable efforts to obtain asset information from the supplemental proceedings; and

(B) if assets subject to execution are discovered as a result of the order required under Subsection (3)(c)(iii)(A) or for any other reason, to obtain the issuance of a writ of execution from a court of competent jurisdiction; or

(iv) the claimant timely filed a proof of claim where permitted in the bankruptcy action, if the nonpaying party has filed bankruptcy; and

(e) [~~(d)~~] the qualified beneficiary is not entitled to reimbursement from any other person.

Such a change solves the problem by removing the qualified beneficiary and nonpayment issues from Subsection 204(3)(b)—the items the homeowner is required to prove.

Residence Lien Recovery Fund Feasibility Study
Interested Party Contact List
Fall 2003

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Gordon Snow, State Representative	435-722-4403	gordonsnow@utah.gov
Curt Webb, State Representative	801-753-2467	curt@cachetitle.com

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Bob Bergman, Utah Mechanical Contractors	801-364-7768	
Taz Biesinger, Utah Home Builders Assoc	801-268-8750	
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Suppliers & Supplier Representatives

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Others

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Logan A Bagley, NACM Business Credit	801-487-8781	www.nacmint.com
Paul Newton, Backman Stewart Title	801-288-8818	
Charlie Evans, lobbyist		Charlie@att.net

(report continued next page)

Attachment #1: **Bonding Viability Survey**

Company	Person	City	Phone	Comments
Barton Insurance	Sterling Broadhead	Salt Lake City	(801) 288-1600	1. Generally will only bond commercial projects 2. 1999 analysis for DOPL: statutory compliance bond worthless (Arizona empirically proves) but easy to get 3. Ivory Homes, *et al*. would qualify but no one smaller (performance & payment) 4. Nevada model (exact duplicate) would solve for financial responsibility but with loss of 25% of current contractors; must stratify bond requirements to solve 5. $250K home working capital & net worth $150K to qualify
Garrett Insurance	Renee	Logan	(435) 752-5414	1. Charge $25 per $1,000 bonded ($4,000 per home @ $160K) 2. Bond would be lesser of 10× working capital or 7× net worth 3. Result: contractor would have to have $16,000 working capital and $25,000 net worth <u>per home</u> to receive bond (@$160K)
Old Republic Surety	Bonnie	Murray	(801) 262-9801	1. Will not bond anything less than $800K 2. Unaware of any surety that will bond residential
Wiseman Insurance	Rob Wiseman	Provo	(801) 377-3060	1. Currently approves less than 50 percent of contractor applicants; expects much higher denial rate if small contractors begin to apply 2. Example bond: $200K would require contractor have $30K cash, significant equity, and clean credit report 3. Cost: $25 per $1,000 bonded for standard bond; $75 per $1,000 for small contractor
Labrum-Foote Insurance	Bernie	St. George	(435) 674-2221	1. Estimated 80% of contractors would not qualify for bond 2. Would require 100% liquid assets backing (i.e. $300K bond would require that contractor have $300K cash in bank)

Attachment #2: **Plain Language Title Insurance Viability**

Company	Person	City	Phone	Comments
Backman-Stuart	Canyon Anderson	Murray	(801) 288-8818	1. Plain language currently same cost as traditional 2. Existence of alternate security and LRF are keys to keeping plain language same cost as traditional 3. Requiring plain language without LRF would dramatically increase cost to homebuyers and agents; exact nature and magnitude of the increase is not know; underwriters are better source for information
Bonneville Title		Ogden	(801) 263-1810	1. Already offering plain language on new construction 2. Cost and availability varies by contract price and contractor credit risk 3. Underwriters ultimately decide whether a contractor is acceptable; criteria vary
Security Title	Wes Jensen	St. George	(435) 673-4405	1. Always issue plain language but not necessarily for new construction 2. Will only issue plain language on new if can guarantee no liens 3. Company probably not willing to or only at substantial fee (10% more than traditional policy minimum) 4. Would not issue plain language without LRF

REPORT END
Klare Bachman RLRF Study 3: 9-23-03